1988 Annual Report

CZAR
RESOURCES LTD.

CZAR RESOURCES LTD.
and Subsidiary Companies

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Corporate Profile

Czar Resources Ltd. is an independent Canadian resource company engaged in the exploration for, and the development, production and marketing of natural gas in Western Canada. Czar was incorporated in 1974 in Alberta and grew rapidly by funding exploration programs through limited partnerships in Canada and the United States. In recent years, Czar's emphasis on natural gas, solely in Canada, has enabled the Company to develop a reserve base of 197 billion cubic feet and increase it's daily production to an average of almost 30 million cubic feet per day in 1988.

As part of Czar's natural gas strategy, the Company has entered into several long term gas contracts for a substantial portion of its reserve base, enabling the Company to continue its ongoing exploration and development program in Alberta and return to an active role in northeastern British Columbia.

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Annual Meeting

The Annual Meeting of the Shareholders of Czar Resources Ltd. will be held on May 25, 1989 at 3:00 p.m. in the Lakeview Room of the Westin Hotel, Fourth Avenue and Third Street S.W., Calgary, Alberta.

Highlights

Financial

	1988	1987
Gross Revenue	**$15,491,060**	$13,692,139
Cash Flow from Operations	**5,061,475**	4,929,976
Cash Flow per Share	**0.18**	0.20
Net Earnings	**1,472,241**	1,895,575
Net Earnings per Share	**0.05**	0.07
Capital Expenditures	**9,984,766**	4,709,343
Total Assets	**$53,972,971**	$41,814,266
Common Shares Outstanding at December 31	**27,637,482**	27,052,406

Operating

	1988	1987
Production (Before Royalties)		
Crude oil and natural gas liquids (BBLS)	**153,843**	148,312
Average daily production (BOPD)	**421**	406
Natural gas (BCF)	**10.8**	8.8
Average daily production (MMCF/d)	**29.4**	24.2
Drilling Activity		
Gas completions	**15**	22
Oil completions	**0**	1
Dry and abandoned	**4**	9
Total Wells	**19**	32
Undeveloped Land Holdings		
Net Acres		
Alberta	**42,473**	49,069
British Columbia	**85,483**	100,673
Total Net Acres	**127,956**	159,742

Reserves

	OIL (MSTB)	GAS (BCF)
Before Royalties		
At December 31, 1988 proved and probable	**1443.1**	**196.9**

Abbreviations

Throughout this report standard oil and gas abbreviations have been used.Their explanation is as follows:

BBLS	Barrels
MSTB	Thousand Stock Tank Barrels
BOPD	Barrels of Oil Per Day
MMCF	Million Cubic Feet
MMCF/d	Million Cubic Feet Per Day
BCF	Billion Cubic Feet

To The Shareholders

I am pleased to report on one of the most successful years in the Company's history. In 1988, Czar Resources Ltd.:

- reported record gross revenues - $15.5 million;
- achieved record natural gas sales - 10.8 BCF; and
- started the largest production facility expansion in the Company's history.

These results, coupled with steadily improving natural gas fundamentals, demonstrate the merits of the Company's concentration on natural gas over the past five years and assure rapid expansion during 1989.

Business Objectives

The Company's primary business objectives continue to be to increase natural gas sales and to maintain the Company's reserve base, while improving Czar's financial structure. The Company was successful in meeting these objectives in 1988.

Czar's concentration on natural gas resulted from Czar developing a large portfolio of gas bearing properties in the early 1980's. At the time of the downturn in the energy industry these properties were in various stages of development. Hence, it was logical for the Company to devote its efforts to fully exploiting these gas pools and to become an aggressive marketer of natural gas.

On closer examination of the North American gas situation, it became apparent that a concentration on natural gas was a good long-term strategic decision. Natural gas appeared to Czar's management to be a North American energy commodity in a mature phase of its exploitation, particularly in the United States.

The United States has very rich gas prone basins and years of exploration have resulted in one of the largest annual gas production volumes in the world. However, the degree of development in the United States has resulted in much of the easily accessible gas being exploited.

The following facts are illustrative of the deterioration of the United States gas reserve base:

- United States reserves have declined steadily since 1969 and in 1987 were at the lowest level since 1945;
- United States gas replacement in 1987 was at its lowest level in ten years;
- rig activity to replace gas reserves has collapsed due to the extended period of low prices;
- recent United States imports of Canadian gas have increased to record levels indicating a substantial import demand at market clearing prices; and
- the relatively poor annual reserve additions during the drilling boom of the early 1980's suggests that most of the gas prone basins have been thoroughly exploited and are reaching the mature stage of their development.

The situation in western Canada however, is more favorable as this basin has been more sparsely drilled and the opportunities for finding large new blocks of gas still exist. Though Canadian gas prices have remained low and the marketing situation is extremely competitive, Czar's premise is that large volumes of gas will be exported from western Canada to the United States at substantially improved prices in the early 1990's.

In order to benefit from this long term view, the Company became an aggressive marketer of natural gas to industrial customers, at market clearing prices. With the cash flow from these industrial sales and the funds raised from the issue of flow-through shares, the Company has been able to rapidly expand its production base despite being financially leveraged.

Recently improved gas demand has brought long term buyers for natural gas reserves back into the market. As long-term contracts have traditionally provided higher prices, Czar, with its upgraded portfolio of market-ready gas was quickly able to take advantage of this changing situation.

Consequently, the Company entered into two long term contracts during 1988 which should provide substantial benefits to Czar throughout the 1990's. The Company is continuing to pursue new initiatives to switch its gas sales from short term industrial markets to long term export purchasers.

In addition to these natural gas initiatives, which were critical to meeting the Company's business objectives, a number of key financial initiatives were also required.

This comprised the issuance of a large block of term preferred shares during 1984, which enabled the Company to pay low interest rates on almost two-thirds of its debt. This was followed by the issuance of $30 million of common shares during 1987, and more recently, by the sale of $10 million of convertible debentures.

These financing efforts have gradually moved the Company back to a more secure financial basis and place the Company in a position either for expansion or a defensive mode should economic growth in North America slow down in the next few years.

Outlook

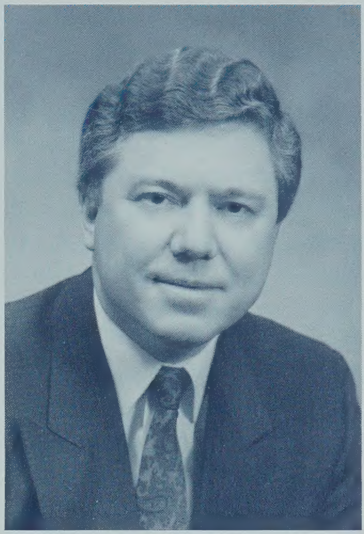
The Company looks forward to 1989 with optimism in that Czar will have:

- assured growth in gas production volumes;
- higher average gas prices under new contracts; and
- limited fixed asset addition requirements as key projects were completed during 1988.

On a more conservative note however, the outlook for the economy is by no means clear and although Czar is positioned with few commitments, an economic downturn would result in reduced growth prospects.

Furthermore, the Company anticipates paying higher interest costs throughout the year as a result of the recent conversion of the Company's term preferred shares, more fully described in the financial section. The effect of the higher fixed charges will be to reduce capital available for additional projects. However, Czar has operated in the past number of years using its available cash flow, complemented with flow-through share funding, and as the Company can internally finance itself even under the most pessimistic circumstances, I anticipate continued growth throughout the year.

Just following year end, Mrs. Bonita Rawlyck, Czar's Chief Financial Officer and Director, left the Company to pursue other career plans. Mrs. Rawlyck worked with the Company through a number of difficult years and we thank her for her contribution and wish her well in the coming years.



On behalf of the Board of Directors of Czar Resources Ltd., I would like to thank the staff for their major efforts, successfully completed during 1988.

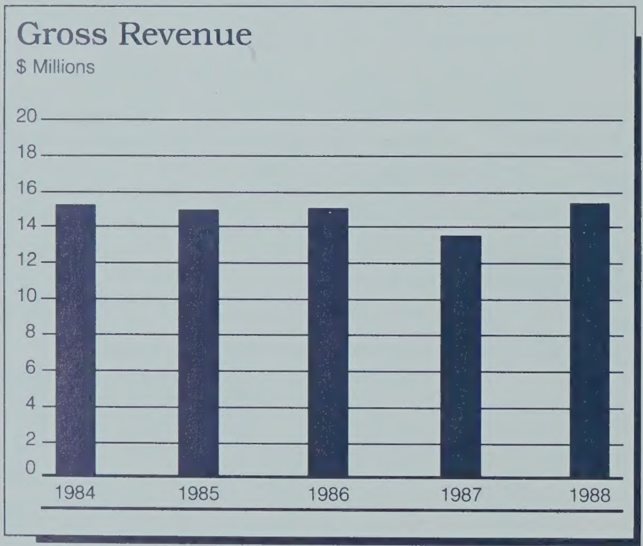
R.W. Lamond
President
March 31, 1989

Financial

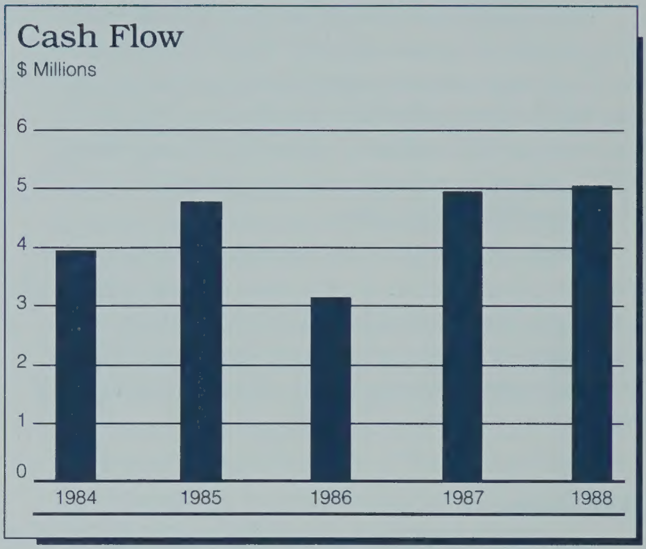
Czar's financial results for 1988 were highlighted by increases in gross revenue and cash flow, reductions in debt servicing charges and an improved coverage of fixed charge.

Revenue

Gross revenue increased to $15.5 million from $13.7 million in 1987, due to significant increases in production volumes of natural gas. Cash flow from operations increased to $5.1 million or $0.18 per share in 1988 from $4.9 million or $0.20 per share in 1987. Increased transportation charges on export gas sales coupled with higher non-cash charges reduced net earnings to $1.5 million or $0.05 per share from $1.9 million in 1987. These additional transportation charges account for the majority of increases in production expenses as Czar's production costs per MCF remained similar to those of 1987.

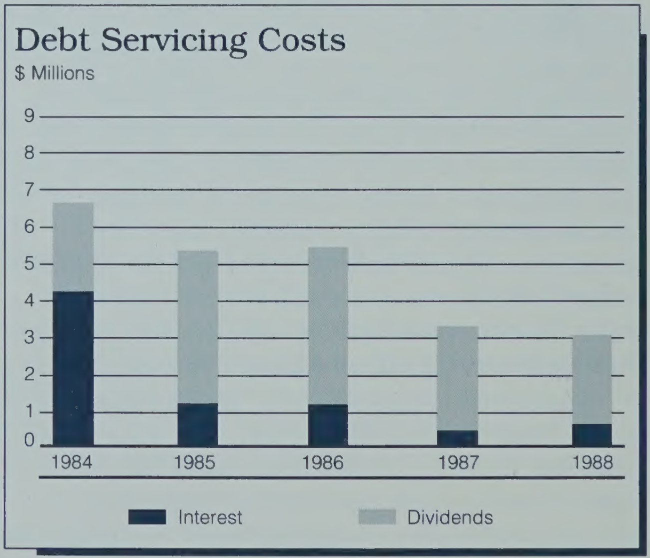


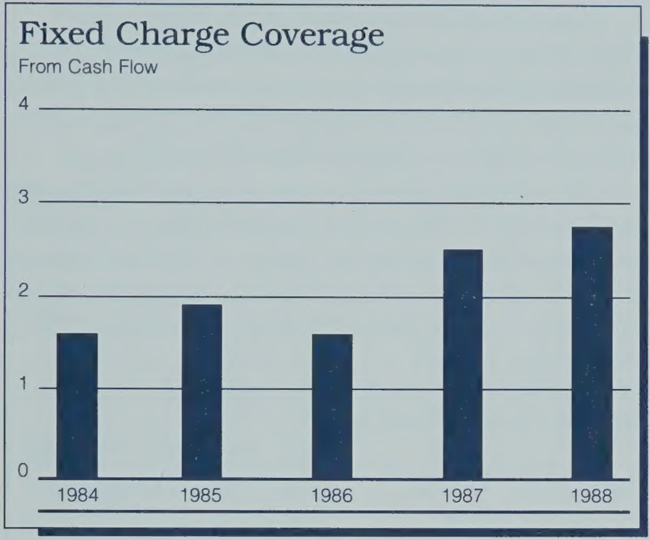
During the year the Company changed its method of reflecting deferred income taxes. While Czar's financial presentation indicates a loss before extraordinary items, the Company's tax pools are sufficient that the extraordinary item "reduction of deferred income taxes" will continue to recur over the foreseeable future.

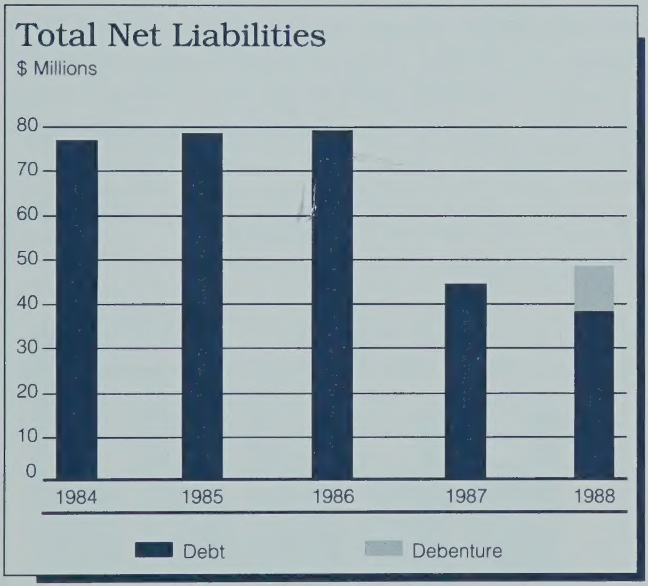


Financing

Czar's successful issuance of $10,000,000 of 8.75% convertible debentures allowed the Company to reduce some of it's higher interest bearing debt and increase it's capital expenditures. Czar's debt servicing charges of $3.1 million were at their lowest level since 1980 and helped improve the Company's fixed charge coverage to 2.7 times. Czar's total net liabilities increased to $48.4 million from $44.4 million in 1987 while its capital additions reached the highest level since 1981.







Several private placements of flow-through shares provided the Company with $954,000 for exploration activities. The Company also entered into two flow-through share arrangements subsequent to year end, one of which resulted in $1.6 million being expended in the first quarter of 1989.

In March of 1989, the Company redeemed $37.5 million of term preferred shares through a facility funded by the Company's banker. While complete terms of the facility have not been finalized, it is likely that it will bear current commercial interest rates. The Company anticipates that substantial increases in production volumes, during 1989, will more than compensate for the higher debt servicing charges.

Capital Expenditures

Czar continued to fund its capital projects from several sources including the issuance of flow-through shares. In 1988 the Company's capital additions of $10 million mainly concentrated on increasing the Company's production capabilities as detailed below:

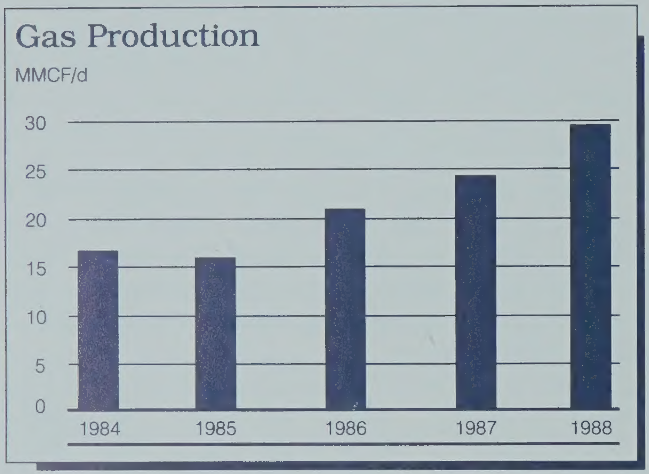
(millions of dollars)	**1988**	1987	1986	1985	1984
Land Acquisition	**$ 1.2**	$ 1.0	$1.0	$0.9	$0.7
Drilling	**3.0**	2.9	1.6	1.2	1.0
Production Facilities	**5.0**	1.2	0.9	4.3	0.8
Other	**0.8**	(0.4)	1.7	0.6	1.3
Total	**$10.0**	$ 4.7	$5.2	$7.0	$3.8

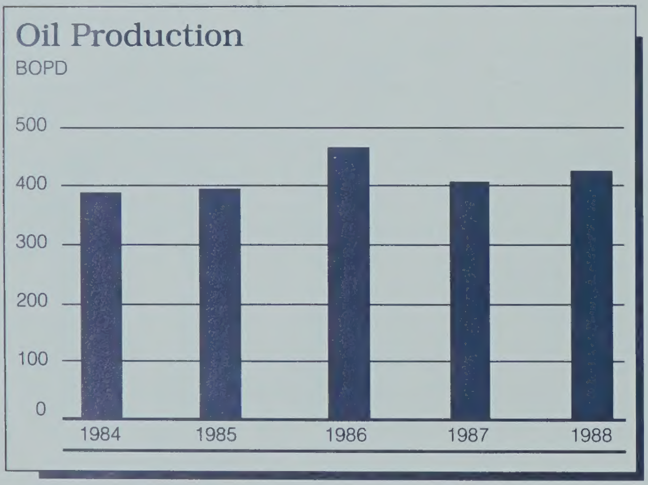
These fixed asset additions were funded from:

(millions of dollars)	**1988**	1987	1986	1985	1984
Cash flow	**$5.0**	$2.7	$3.2	$4.8	$3.9
Flow-through shares	**1.0**	2.0	0.8	–	–
Working capital or debt	**4.0**	–	1.2	2.2	–
Total	**$10.0**	$4.7	$5.2	$7.0	$3.9

Production

As a result of new wells being connected to market, gas sales increased by 21% to 29.4 MMCF/d compared with 24.2 MMCF/d in 1987. Oil and natural gas liquids production increased marginally to 421 BOPD.





Throughout the year Czar continued to place high working interest wells on stream, both to industrial contracts and to new long term export contracts. Key gas wells were connected at Drumheller, Gadsby, Fenn West and Wimborne in Alberta and at Helmet and Peggo in British Columbia. These wells, in which Czar holds interests ranging from 30% to 85%, will result in a net production increase of approximately 10 MMCF/d.

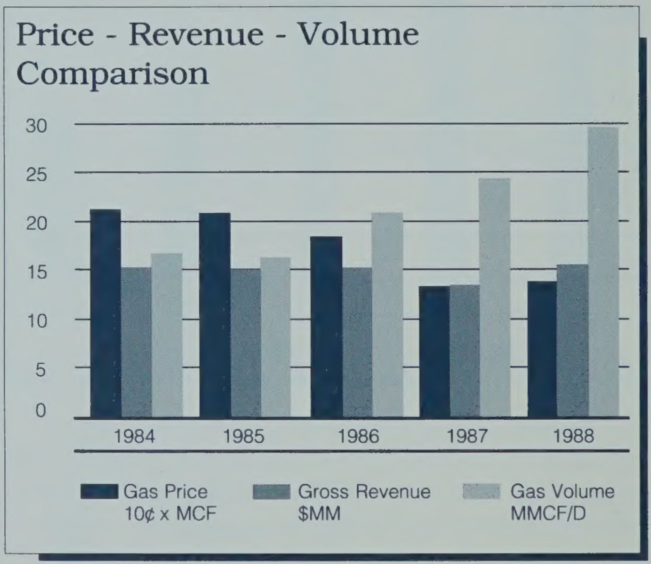
Average gas prices received by Czar were slightly higher than those for 1987; however higher interruptible transportation costs, which are billed separately in some contracts, resulted in real netbacks similar to those obtained in 1987.

Oil prices on average were reduced from those of 1987, due to OPEC instability throughout the year; recent higher demand from the continued expansion of world-wide economic activity has resulted in oil prices returning to more satisfactory levels in early 1989.

Average Product Prices

	1988	1987	1986	1985	1984
Gas - $/MCF	**1.39**	1.33	1.69	2.07	2.11
Oil and NGL - $/BBL	**14.47**	19.10	17.47	36.26	34.99

The following graph illustrates that despite increased volumes of natural gas marketed by the Company, declining natural gas prices have resulted in gross revenue remaining essentially flat over the last five years.



Reserves

During 1988, record volumes of natural gas were produced, and reserve additions from Czar's drilling program successfully replaced all of its production.

An evaluation of the Company's oil and natural gas properties by an independent petroleum engineering consultant as at December 31, 1988 is summarized below. The summary is before deducting royalties and includes Alberta royalty tax credits.

	Natural Gas BCF	Oil & NGL MSTB	Present Value 000's Undiscounted	Present Value 000's Discounted at 15%
Proved				
Producing	79.7	939	$116,844	$51,969
Non-producing	80.1	351	146,514	30,141
Undeveloped	6.6	–	9,171	1,666
Total Proved	166.4	1,290	272,529	83,776
Probable	30.5	153	55,222	8,061
Total Proved & Probable	196.9	1,443	$327,751	$91,837
1988 Production	10.8	154		
Reserve Life (years)	18.2	9.4		

The Company's natural gas reserves are divided almost evenly between Alberta and British Columbia allowing the Company to access gas markets served by the major pipelines from both provinces.

	Volume BCF	%
Alberta		
Proved-Producing	35.9	18.2
- Non-Producing	46.2	23.5
Probable	14.1	7.2
Total	96.2	48.9
British Columbia		
Proved-Producing	43.8	22.2
- Non-Producing	40.5	20.6
Probable	16.4	8.3
Total	100.7	51.1

As a result of the Company placing increasing volumes of natural gas on stream, the quantity of proved producing reserves has steadily increased to almost 80 BCF, which represents 41% of total volumes, up from 37% in 1987.

Natural Gas Marketing

During 1988, the Company continued its policy of maintaining existing gas markets where possible, and expanding into new areas according to the Company's long range gas marketing plans.

Total gas sales to industrial markets increased from 1987 due primarily to the opportunity to market gas directly into the United States from British Columbia, as a result of a decision by Northwest Pipeline Corporation to become an "open access carrier" early in 1988. Czar promptly entered into a number of short-term marketing contracts and commenced delivering volumes ranging between 15 MMCF/d and 20 MMCF/d on a month to month basis.

Direct gas sales for the year totalled:

(BCF)*	**1988**	1987	1986	1985	1984
Alberta - Industrial	**10.1**	9.3	8.7	7.8	9.7
B.C. - Industrial	**7.8**	5.5	8.0	2.0	1.5
U.S.- Export	**5.7**	2.2	1.1	2.3	–
Total	**23.6**	17.0	17.8	12.1	11.2

*Includes Czar and working interest participants

While Czar's gas marketing strategy has been to sell increasing volumes at market clearing prices, it has become clear that the highly competitive short term market does not provide sufficiently assured takes and pricing for long term stability.

As a result of the gradual strengthening in gas demand since late 1987, Czar redirected its efforts towards contracting large blocks of the Company's undedicated reserves to long term export contracts.

In February, 1988, the Company entered into a gas sales contract with KannGaz Producers Ltd. under which approximately 53 BCF of Alberta reserves were dedicated for a fifteen year term. Deliveries commenced shortly thereafter, and Czar is presently producing approximately 8 MMCF/d to this contract, at satisfactory prices.

In April, 1988, the Company entered into an agreement with Alberta and Southern Gas Co. Ltd. to supply up to 220 BCF of gas from British Columbia over a twenty year period. As Alberta and Southern, which primarily services the California market, historically has yielded higher than average prices and levels of take to its producers, this contract will provide Czar with a stable level of cash flow throughout the 1990's. Deliveries of 10 MMCF/d are scheduled to commence on or about November 1, 1989 and will increase to 15 MMCF/d in 1990, 30 MMCF/d in 1991 and 40 MMCF/d in 1992.

During the year Czar renegotiated the terms of its contract with Sherritt Gordon Mines Limited. The primary changes will increase production volumes over the next two years to a maximum of 30 MMCF/d, and will permit Czar to produce its properties on a deliverability basis. These changes allow the Company to more fully utilize its existing producing properties by increasing volumes from capable wells without requiring additional production facilities to meet contractual volumes.

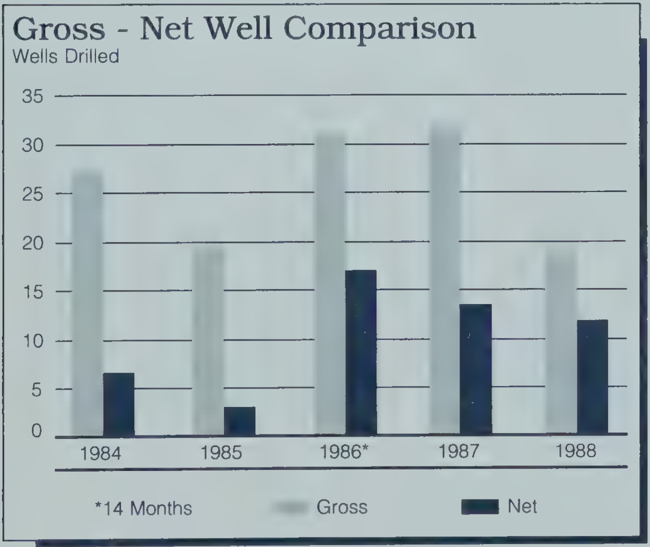
Exploration

During 1988, Czar continued to concentrate on the exploration for natural gas in central Alberta and northeastern British Columbia. In Alberta exploration targets were shallow Cretaceous sands while in British Columbia Czar concentrated on the development of gas pools in the Devonian in the Helmet area.

Successful wells were drilled at Gadsby, Fenn, Erskine, Mikwan and Wimborne in Alberta and at Helmet and Peggo in British Columbia. A highlight of the Alberta program was the successful delineation of a gas pool in the Wimborne area where Czar holds interests averaging 83.5% in five gas wells. These wells were placed on stream late in 1988 and are presently producing at 3.5 MMCF/d.

Czar's drilling program which is aimed at Czar participating for increasing interests, resulted in the following wells:

	1988		1987	
	Gross	**Net**	Gross	Net
Gas Wells	**15**	**9.1**	22	9.0
Oil Wells	**0**	**0**	1	0.9
Dry Holes	**4**	**2.7**	9	3.9
Total	**19**	**11.8**	32	13.8



In British Columbia, Czar resumed active operations in the Helmet area early in 1988. Since then, the Company has successfully drilled and cased eight potential gas wells. As a result of the Company's existing pipeline network, four of the wells have already been placed on stream. The Helmet reserves are dedicated to the long term Alberta and Southern contract and consequently Czar will continue to be active there in the next winter drilling season.

During the year, the Company drilled the following significant gas wells:

PEGGO d-A69-D/94-P-8

This well was completed in the Jean Marie zone and is presently producing at a rate of 4.5 MMCF/d. A second well was drilled at Peggo early in 1989, and has also been put on production.

FENNBV 8-22-36-20 W4M

This dual zone well capable of producing at a rate of 2.5 MMCF/d, was placed on stream in early 1989. The Company has a 83.5% working interest in the well.

ERSKINE 12-4-39-20 W4M

The Company has an 84.5% working interest in this dual zone gas well which was placed on stream at a rate of 1.5 MMCF/d early in 1989.

GADSBY 10-34-37-19 W4M

This well is capable of commercial production from two zones for a combined 1.8 MMCF/d. The Company has a 21.7% working interest in this well.

Consolidated Balance Sheet

	December 31, 1988	December 31, 1987
Assets		
Current Assets		
Cash	$ 5,830,086	$ –
Accounts receivable	4,680,796	4,941,850
Inventory of supplies, at lower of cost and net realizable value	230,901	360,152
	10,741,783	5,302,002
Fixed Assets (note 3)		
Petroleum and natural gas leases and rights including exploration, development and equipment thereon, at cost	58,441,682	48,457,205
Other	1,169,867	1,331,839
	59,611,549	49,789,044
Accumulated depletion and depreciation	(17,077,155)	(13,276,780)
	42,534,394	36,512,264
Deferred Financing Costs, net of amortization	696,794	–
	$ 53,972,971	$ 41,814,266
Liabilities		
Current Liabilities		
Accounts payable and accrued liabilities	$ 10,509,988	$ 7,965,158
Current portion of long-term debt	631,833	558,996
	11,141,821	8,524,154
Long-term Debt (note 4)	493,358	3,682,421
Convertible Debentures (note 5)	10,000,000	–
Preferred Shares of a Subsidiary Company (note 2)	37,500,000	37,500,000
Capital Stock and Deficit		
Capital Stock (note 6)	48,933,952	47,676,092
Deficit	(54,096,160)	(55,568,401)
	(5,162,208)	(7,892,309)
	$ 53,972,971	$ 41,814,266

Approved by the Board:

, Director , Director

Consolidated Statement of Earnings

Year ended December 31, 1988

	1988	1987
		(see note 7)
Revenue		
Production	$14,777,811	$12,761,738
Less: Provincial royalties	1,832,419	1,620,022
Freehold royalties	766,497	705,709
Alberta royalty tax credit	(831,490)	(723,732)
	1,767,426	1,601,999
Net production revenue	13,010,385	11,159,739
Principal and interest from property dispositions	1,470,600	1,576,068
Processing revenue	645,457	728,825
Other	364,618	227,507
	15,491,060	13,692,139
Expenses		
Production	4,990,074	3,537,660
General and administrative	2,311,220	1,736,902
Interest on long-term debt	605,411	316,611
Interest and other	165,763	208,556
Depletion and depreciation	4,016,234	3,423,841
	12,088,702	9,223,570
Earnings Before Undernoted Items	3,402,358	4,468,569
Dividends on preferred shares of a subsidiary company (note 2)	2,457,117	2,962,434
Earnings Before Deferred Income Taxes and Extraordinary Items	945,241	1,506,135
Deferred income taxes (note 7)	1,278,035	1,505,930
Earnings (Loss) Before Extraordinary Items	(332,794)	205
Extraordinary Items		
Gain on sale of subsidiary companies (note 10)	527,000	389,440
Reduction of deferred income taxes on application of prior years' losses	1,278,035	1,505,930
Net Earnings	$ 1,472,241	$ 1,895,575
Per Common Share (note 9)		
Earnings (loss) before extraordinary items	$(0.01)	$0.00
Net earnings	$ 0.05	$0.07
Cash flow - basic	$ 0.18	$0.20
- fully diluted	$ 0.16	$0.18

Consolidated Statement of Source and Use of Cash

Year ended December 31, 1988

	1988	1987
Operating Activities		
Earnings (loss) before extraordinary items	**$ (332,794)**	$ 205
Depletion and depreciation	**4,016,234**	3,423,841
Write-down of inventory	**100,000**	–
Deferred income taxes	**1,278,035**	1,505,930
Working capital provided by operations	**5,061,475**	4,929,976
Change in non-cash working capital items related to operations	**2,835,135**	(2,230,032)
	7,896,610	2,699,944
Investing Activities		
Additions to fixed assets		
Current operations	**(9,030,766)**	(2,709,343)
Flow-through share arrangements	**(954,000)**	(2,000,000)
Collection of notes receivable	**527,000**	389,440
Financing Activities		
Decrease in bank loan	**(2,970,000)**	(14,530,000)
Redemption of preferred shares of a subsidiary company	**–**	(17,500,000)
Sale of convertible debentures, net of financing costs of $750,392	**9,249,608**	–
Capital lease obligations	**612,770**	–
Decrease in liability to limited partnerships	**(758,996)**	(646,583)
Common shares issued and to be issued		
Pursuant to financial restructuring, net of issue costs of $1,179,193	**–**	28,820,807
Pursuant to flow-through share arrangements	**954,000**	2,000,000
For cash	**750**	15,000
Settlement of liability to limited partnerships	**200,000**	960,000
Pursuant to employee savings plan	**103,110**	–
Share issue costs	**–**	(93,926)
Increase (Decrease) in Cash	**5,830,086**	(2,594,661)
Cash at Beginning of Year	–	2,594,661
Cash at End of Year	**$ 5,830,086**	$ –

Consolidated Statement of Deficit

Year ended December 31, 1988

	1988	1987
Deficit at Beginning of Year	**$(55,568,401)**	$(57,370,050)
Share Issue Costs	–	(93,926)
Net Earnings	**1,472,241**	1,895,575
Deficit at End of Year	**$(54,096,160)**	$(55,568,401)

Auditors' Report

To the Shareholders of
Czar Resources Ltd.

We have examined the consolidated balance sheet of Czar Resources Ltd. as at December 31, 1988 and the consolidated statements of earnings, deficit and source and use of cash for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Company as at December 31, 1988 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Canada
March 21, 1989

Signed Thorne Ernst & Whinney
Chartered Accountants

Notes to Consolidated Financial Statements

Year ended December 31, 1988

1. Accounting Policies

(a) Principles of Consolidation

The consolidated financial statements include the accounts of Czar Resources Ltd. and its subsidiary companies, which are wholly-owned.

(b) Petroleum and Natural Gas Operations

(i) The Company follows the full cost method of accounting for petroleum and natural gas operations whereby all costs of exploring for and developing petroleum and natural gas reserves are capitalized by cost centre. A separate cost centre is established for each country in which the Company operates, presently Canada. Costs include land acquisition costs, geological and geophysical expenditures, carrying charges on non-producing property, costs of drilling both productive and non-productive wells, related overhead expenditures and capitalized interest related to major development projects. Costs of acquiring and evaluating unproved properties and certain major development projects are excluded from the depletion calculation until it is determined whether or not proved reserves are attributable to those properties or major development projects are complete or impairment occurs. Costs are depleted by cost centre using the composite unit of production method based upon estimated proved reserves after royalties. Crude oil reserves are converted to equivalent units of natural gas based on the relative energy content of each product.

(ii) The net book value in each cost centre which can be carried forward for amortization against revenues of future periods (the "cost centre ceiling") is limited to an amount equal to the estimated future net revenues from proved reserves, based on current prices and costs, plus the lower of cost or estimated fair value of unproved properties and major development projects. The aggregate net book value of all cost centres less deferred income taxes (the "enterprise ceiling") is limited to estimated future net revenues and value of unproved properties and major development projects for all cost centres less estimated future general and administrative expenses, financing costs and income taxes.

(iii) Under certain drilling programs, a significant portion of the consideration for the sale of properties by the Company is receivable in installments. Principal and interest payments, in the aggregate, may not exceed a fixed percentage of net revenue from the wells drilled. Unpaid principal installments total $38,901,200 at December 31, 1988 (1987 - $40,102,264). Such principal and interest payments are recorded as and when received.

(iv) All of the Company's exploration and development activities related to petroleum and natural gas are conducted with others; the Company records only its proportionate interest in such activities.

(c) Depreciation

Depreciation of petroleum and natural gas production equipment and related facilities is provided on the composite unit of production method based on estimated proved reserves after royalties of each cost centre. Depreciation of other equipment is provided on a straight-line basis at rates which are estimated to amortize the cost of the assets over their useful lives.

(d) Deferred Financing Costs

Deferred financing costs relating to the convertible debentures are amortized on a straight-line basis over the term of the debentures.

2. Financial Restructuring

Debt Restructuring Agreement

In 1987 the Company and its banker (the "Bank") restructured (the "Restructuring") the Company's obligations to the Bank pursuant to a Debt Restructuring Agreement effective for interest and dividend determination as of October 30, 1986, such that $30 million of the Company's indebtedness to the Bank was satisfied in exchange for the issuance to the Bank of 12,787,269 common shares (46.3% of the issued and outstanding common shares of the Company). The Restructuring was completed on September 23, 1987 at which time the Company also issued to the Bank warrants to acquire additional common shares (see note 6(d)).

After the Restructuring the Bank held preferred shares of a subsidiary of the Company in the aggregate amount of $37.5 million ("New Financing Preferred Shares") which have the following terms and conditions:

(a) bear dividends at the rate of approximately 7.35% to February 15, 1988 and thereafter at the rate of 50% of the weighted average of the Bank's prime lending rate plus 1% payable quarterly in arrears;

(b) are retractable at the option of the holder and redeemable at the option of the subsidiary for an amount equal to the issue price plus accrued and unpaid dividends, at any time without penalty; and

(c) are subject to mandatory redemption or purchase from time to time based on cash flow, as described below, and in any event on or before March 15, 1989. See note 12.

It is also a term of the New Financing Preferred Shares that excess cash flow of the Company (as defined) in any fiscal year in excess of $200,000 including cash from all sources, but not including the net proceeds of the issue of convertible debentures as described in note 5, will be advanced by the Company to the subsidiary to fund the redemption of New Financing Preferred Shares. Additionally, permissible capital expenditures are deducted in determining defined excess cash flow.

The Company's obligations under the Restructuring are secured by a fixed charge debenture on certain assets and a floating charge debenture on all assets of the Company and assignments of accounts receivable and certain petroleum and natural gas properties and revenue interests therein.

The Company has agreed with the Bank not to make any distributions, including dividends, to its shareholders without the consent of the Bank. The Company has agreed to limit its working capital deficiency to $1,000,000 after December 31, 1988 which limit may be increased to a maximum of $3,000,000 under certain circumstances.

Common Share Offerings

The Company cannot, without the consent of the Bank: (i) issue common shares or rights to common shares at less than $1.25 per share, or (ii) issue in any 12 month period common shares of the Company in excess of 20% of the common shares outstanding at the commencement of such period without the approval by special resolution of each class of shareholders, voting separately. In addition, subject to regulatory approval, the Bank is entitled to participate up to its proportionate shareholding interest in all future common share issues on the same basis as third parties other than in connection with common shares issued pursuant to stock option agreements entered into after October 31, 1986.

In the event that the Company issues common shares, other than flow-through shares, or securities convertible into common shares, the Bank has the option to participate on a secondary basis such that 50% of such offering shall be comprised of common shares then held by the Bank. Alternatively, the Bank may require that 25% of the proceeds of any such issue be paid to it and to apply such proceeds, at the election of the Company, either against the operating line as a permanent reduction of the limit thereof or to fund the redemption of the New Financing Preferred Shares, or any combination of the foregoing.

Operating Lines of Credit and Bank Borrowings

The Company has agreed with the Bank that for the period commencing October 30, 1986 and ending September 22, 1989, either debt to the Bank or the operating line shall be permanently reduced or the New Financing Preferred Shares shall be redeemed (to the extent not already redeemed under the share redemption requirement) or any combination of the foregoing, at the rate of $100,000 per quarter plus 60% of the annual cash flow (as defined) from operations of the Company and its subsidiaries in excess of $2,000,000 for that particular year. These provisions continue after September 22, 1989 if no agreement has been reached on new arrangements by that time. The credit facility (see note 12 (a)) is reviewed annually and the loans are secured by a fixed charge debenture on certain assets and a floating charge debenture on all assets of the Company and assignments of accounts receivable and certain petroleum and natural gas properties and revenue interests therein. The Company requires the consent of the Bank to seek additional borrowing from any person except the Bank.

3. Fixed Assets

Fixed assets include overhead expenditures which are incurred in the exploration and development of oil and gas properties, amounting to $633,200 in the year ended December 31, 1988 (1987 - $422,769). The Company has not capitalized any interest costs or excluded costs from depletable costs in 1988 or 1987, pursuant to its accounting policies.

4. Long-term Debt

	1988	1987
Bank loan, at prime plus 1/4%	**$ –**	$2,970,000
Obligations under capital leases	**612,770**	–
Liability to limited partnerships	**512,421**	1,271,417
	1,125,191	4,241,417
Current portion of long-term debt	**631,833**	558,996
	$ 493,358	$3,682,421

Future minimum lease payments under capital leases are as follows:

1989	$196,644
1990	196,644
1991	196,644
1992	224,902
	814,834
Less amounts representing interest ranging from 13.8% to 15%	202,064
	612,770
Less current portion	119,412
	$493,358

The liability to limited partnerships is non-interest bearing, to be paid in monthly installments of approximately $47,000 until November, 1989 and secured by a fixed charge debenture on certain fixed assets.

5. Convertible Debentures

The unsecured convertible debentures bear interest at 8.75% per annum payable semi-annually on June 15 and December 15 and mature on June 15, 1995.

The debentures are convertible into common shares of the Company at the option of the holder at any time prior to June 16, 1995 at a conversion price of $1.70 per common share. The conversion price is subject to adjustment in certain events.

The debentures are not redeemable prior to July 1, 1991. Thereafter, and prior to December 31, 1993 they are only redeemable if the common shares of the Company have traded at least at 125% of the conversion price for 20 consecutive trading days. Thereafter they are redeemable at any time. The debentures are redeemable at par plus accrued interest and an amount equal to 103% of par if redeemed prior to July 1, 1992 which reduces by 1% for each succeeding twelve month period.

6. Capital Stock and Deficit

(a) Authorized Capital Stock

10,000,000 First preference shares issuable in series.
10,000,000 Second preference shares issuable in series
Unlimited number of common shares

(b) Issued and to be Issued Common Shares

	Number of Shares	Amount
Balance December 31, 1987	27,052,406	$47,676,092
Issued pursuant to liability to limited partnerships	100,000	200,000
Issued pursuant to flow-through share arrangements	405,000	954,000
Issued and to be issued pursuant to employee savings plan (note 6 (e))	79,078	103,110
Issued for cash on exercise of stock options	500	750
Issued to Bank pursuant to common share purchase warrants	498	–
Balance December 31, 1988	27,637,482	$48,933,952

(c) Common Share Options

An employee holds options to purchase 6,000 common shares of the Company at an exercise price of $1.65 on or before July 2, 1989.

(d) Common Share Purchase Warrants

The Company's banker has common share purchase warrants which entitles it to purchase common shares as follows:

Number of Shares	Price ($)	Expiry Date
232,571	1.86	May 15, 1989
232,571	1.60	October 31, 1989
232,571	2.16	October 31, 1990
232,571	1.71	October 31, 1991
232,571	2.09	September 23, 1992

The Company's banker also has common share purchase warrants to acquire 5,976 common shares at no cost which are exercisable in the event of the exercise of employee options which were in existence on October 30, 1986. These warrants expire August 1, 1989. (See note 2).

(e) Employee Savings Plan

On January 1, 1988 the Company instituted an employee savings plan which provides for employee savings of up to 5% of salary which will be matched by the Company in the form of common shares. During the year ended December 31, 1988 employees became entitled to receive 79,078 common shares.

(f) Flow-through Share Arrangements

Subsequent to December 31, 1988 the Company entered into various arrangements to issue an aggregate of 2,368,333 common shares for an aggregate of $3,570,000 cash consideration which must be expended by various dates (all prior to December 31, 1989) on qualifying expenditures related to the exploration for petroleum and natural gas.

7. Deferred Income Taxes

For the year ended December 31, 1988 the Company retroactively changed the manner in which it presents the recurring reduction in deferred income taxes realized on the application of prior years' losses to record a provision for deferred income taxes and an extraordinary item to eliminate the deferred tax provision by recognizing the benefit of prior years' losses.

The effect of this change was to reduce earnings before extraordinary items by $1,278,035 ($0.05 per share) in 1988 and $1,505,930 ($0.06 per share) in 1987. The change had no effect on reported net earnings.

At December 31, 1988, the Company had approximately $48,000,000 of tax costs in excess of net book value available to reduce future years' income for tax purposes which potential tax benefit has not been reflected in the financial statements.

Earnings before deferred income taxes and extraordinary items differ from taxable income for accounting purposes. The reconciling items are as follows:

	1988	1987
Earnings before deferred income taxes and extraordinary items	$ 945,241	$ 1,506,135
Increase (decrease) in taxable income resulting from:		
Non-deductible preferred share dividends	2,457,117	2,962,434
Non-deductible provincial royalties and lease rentals	2,080,769	1,812,835
Other non-deductible items	108,569	5,036
Non-deductible depletion	340,298	281,222
Alberta royalty tax credit	(831,490)	(723,732)
Resource allowance	(1,699,131)	(2,015,711)
Earned depletion allowance	(682,148)	(816,361)
Taxable income for accounting purposes	$ 2,719,225	$ 3,011,858
Deferred income taxes at the combined basic federal and provincial tax rate	$ 1,278,035	$ 1,505,930

8. Segmented Information

The Company has a single line of business, which is the exploration for and the development and production of petroleum and natural gas in Canada. The Company's production revenue includes $2,985,000 ($2,500,000 U.S.) of export sales to the United States (1987 - $709,000; $545,000 U.S.).

9. Net Earnings and Cash Flow Per Common Share

Net earnings and cash flow per common share are calculated using the weighted average number of common shares outstanding during the year of 27,393,230 (1987 - 26,194,943) . The calculation of cash flow per common share is based on "working capital provided by operations" as reflected in the Consolidated Statement of Source and Use of Cash.

10. Gain on Sale of Subsidiary Companies

In 1986 the Company received two promissory notes aggregating $2.8 million as consideration for the sale of shares of certain subsidiaries and because payment of the notes is dependent on certain future events, any gain will be recorded as payment on the notes is received. To December 31, 1988 the Company has received $916,440 in respect of these notes (1987 - $389,440).

11. Related Party Transactions

In 1986 a corporation of which a shareholder, director and senior officer of the Company is a major shareholder, entered into a joint venture agreement with the Company for participation to a specified maximum in exploration and development of essentially all new prospects of the Company. The corporation earns an interest ranging from 72.5% to 77.5% by paying 100% of the costs related to the participation interest. In the year ended December 31, 1988 the corporation made expenditures of $1,459,111 (1987 - $729,879) pursuant to the agreement. At December 31, 1988 this corporation was indebted to the Company in the amount of $411,323 (1987 - $598,599).

In January, 1989 a new joint venture agreement was entered into whereby the corporation will earn an interest ranging from 80% to 85% by paying 100% of the specified costs related to the participation interest. The Company is required to pay other specified costs.

12. Subsequent Events

(a) Bank Refinancing

On March 15, 1989 the Company obtained an interim bank demand loan in the amount of $37,500,000, the proceeds of which were used to redeem the New Financing Preferred Shares. The loan bears interest at the bank prime rate plus 1/4 percent and is subject to the same security, terms and conditions as the Debt Restructuring Agreement. The Company's total credit facility at March 15, 1989 is $38,630,110. The Company and its banker have agreed to work toward a long-term loan arrangement prior to April 15, 1989. Management has had discussions with its banker wherein the banker confirmed that is has no present intention of demanding repayment of the $37,500,000 prior to January, 1990 except for amounts that would have been paid under the excess cash flow payment requirements of the New Financing Preferred Shares (see note 2).

(b) Flow-through Share Arrangements

Reference is made to note 6(f).

CZAR RESOURCES LTD.
and Subsidiary Companies

Corporate Information

Corporate Office	Suite 2100, 144 Fourth Avenue S.W., Calgary, Alberta, T2P 3N4, Tel: (403) 265-0270
Directors	
Robert W. Lamond	Chairman of the Board, President & Chief Executive Officer, Calgary, Alberta
Brian C. Bentz	Vice-President, Finance, H.A. Simons (Overseas) Ltd., Vancouver, B.C.
Charles A. Teare	President, Orbit Oil & Gas Ltd., Calgary, Alberta
Allan R. Twa	Partner, Burnet Duckworth & Palmer, Calgary, Alberta
Officers and Senior Employees	
P. Richard Ewacha	Vice-President, Production
Sharon P. Runge	Land Manager
Herbert J. Visscher	Exploration Manager
Paul M. Boechler	Controller and Chief Financial Officer
Donald K. Clark	Production Manager, British Columbia
Philip W. Payzant	Production Manager, Alberta
Russ M. Sych	Senior Production Foreman, Alberta
Warren M. Smith	Senior Production Foreman, British Columbia
Legal Counsel	
Burnet, Duckworth & Palmer	Suite 3200, 425 First Street S.W., Calgary, Alberta T2P 3L8
Auditors	
Thorne Ernst & Whinney	Suite 1200, 205 Fifth Avenue S.W., Calgary, Alberta T2P 4B9
Registrar and Transfer Agent	
Montreal Trust	411 Eighth Avenue S.W., Calgary, Alberta T2P 1E7
Wholly-Owned Subsidiaries	
Czar Financing Alberta Ltd.	Calgary, Alberta
Czar Gas Corporation Inc.	Calgary, Alberta
Stock Listings	
The Toronto Stock Exchange	Trading Symbol CZR
The Alberta Stock Exchange	Trading Symbol CZAR

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CZAR RESOURCES LTD.
and Subsidiary Companies

PRODUCT PRICES

Product prices received by the Company for oil and gas sales averaged:

	1988	1987
Natural Gas — $/MCF	$ 1.40	$ 1.37
Oil and natural gas liquids— $/BBL	$15.81	$18.50

Spot gas prices continued to show stability through the summer months of 1988 and now appear to have resumed an upward trend.

GAS MARKETING

Gas sales to each of Czar's market sectors showed improvements during 1988, with larger sales to the United States greatly exceeding 1987 levels.

INDUSTRIAL GAS SALES	1988	1987
	Billions of Cubic Feet*	
Alberta — Industrial	5.3	4.7
B.C. — Industrial	3.2	2.9
Export	3.6	1.4
Total	12.1	9.0

*Includes Czar and partners

As described more fully in the first quarter report of this year, the Company entered into two long-term gas agreements in the first three months of 1988 to supply up to 273 BCF of natural gas held by Czar and its working interest partners during the terms of the contracts.

One contract, with KannGaz Producers Ltd., involves the sale of 53 BCF of Alberta natural gas over 15 years. Production began at 5 MMCF/D in February 1988, and will increase to 10 MMCF/D on November 1, 1988. Czar's share of this contract is expected to average 50 percent.

A second contract with Alberta and Southern Gas Co. Ltd. provides for the sale of 220 BCF of British Columbia gas over 20 years beginning in 1990. Sales will begin with phased-in daily contract quantities starting at 15 MMCF/D on November 1, 1990, increasing to 30 MMCF/D on November 1, 1991 and 40 MMCF/D on November 1, 1992. Czar anticipates its share of this contract to average 50 percent.

EXPLORATION

During the first half of the year the Company drilled twelve wells of which nine were completed as natural gas wells.

	1988	1987
GAS WELLS	9	6
DRY HOLES	3	—
TOTAL	12	6

AR44

Three wells were completed as potential gas wells in north-eastern British Columbia. A new well at Helmet, d-91-J/94-P-7, in which Czar has a 41.2% working interest, is currently producing an average of 4.6 million cubic feet per day.

Exploration activity was relatively quiet in the second quarter of the year while the Company installed facilities in the Erskine, Helmet and Flatrock areas. Exploration will resume in north-eastern British Columbia in the winter months in order to develop gas reserves for the Company's long-term contracts.

OUTLOOK

The completion of the debenture financing has provided the Company with long-term financing to develop and tie-in reserves for sale to its long-term contracts.

With the Company's marketing success providing the outlet for future gas discoveries, and with deregulation of major pipelines in Canada and the United States virtually completed, gas production should increase steadily over the next few years.

On behalf of the Board,

R. W. Lamond
Chairman

August 23, 1988

CZAR RESOURCES LTD.

Suite 700, 425 First Street S.W.
Calgary, Alberta T2P 3L8

Printed in Canada

CZAR RESOURCES LTD.

INTERIM REPORT TO SHAREHOLDERS

6 MONTHS ENDED JUNE 30, 1988

CZAR RESOURCES LTD.
and Subsidiary Companies

AUG 31, 1988

On behalf of the Board of Directors of Czar Resources Ltd. I am pleased to report the results of the Company's operations for the six months ended June 30, 1988.

The highlight of the second quarter was the sale of $10 million of convertible debentures. This issue provides the Company with long term fixed rate financing, will fund an expansion of Czar's production facilities and provides a greater degree of financial flexibility than Czar has enjoyed for a number of years.

FINANCIAL

Gross revenue of $7.7 million was slightly higher than revenue of $7.5 million for the same period in 1987. Though natural gas production increased by 14% over 1987, and prices were steady, the Company's 1987 results included a rebate from Westcoast Transmission for a prior year which was approximately $500,000 higher than a similar adjustment in 1988. Operating costs also increased due to the commencement of production from new properties.

Cash flow, after preferred share dividends, totalled $2.9 million or $.11 per share, and net earnings were $1.2 million, or $.04 per share. Under current circumstances the Company will not pay any income tax in the foreseeable future. Therefore deferred income tax expenses and corresponding recoveries have been treated for financial statement presentation purposes as recurring and offsetting items.

The Company financed its exploration activity from the issue of $726,000 in flow-through shares. The Company's development drilling and equipping expenditures of $3.2 million were incurred mainly in central Alberta and included a major compressor and sales line project in the Drumheller area.

The Company closed its $10 million, 8.75% convertible debenture issue at the end of June. Three million of the net proceeds of $9.3 million was used to repay short term bank debt and the remainder has been retained as working capital. These funds will be used to finance production facilities and development of the Company's natural gas reserves in order to increase production to existing gas contracts.

PRODUCTION

For the first six months of 1988 Czar's production volumes, before royalties, were:

	1988	1987
Natural gas — MMCF/D	29.3	25.8
Oil and natural gas liquids — BOPD	424	403

Peak gas production was reached in March, 1988, at 31.3 million cubic feet per day.

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF EARNINGS
SIX MONTHS ENDED JUNE 30, 1988
(unaudited)

	1988	1987 (restated)
Revenue		
Production	$ 7,457,119	$ 7,143,292
Less: Provincial royalties	914,687	935,076
Freehold royalties	374,902	425,816
Alberta royalty tax credit	(396,992)	(341,452)
	892,597	1,019,440
Net production revenue	6,564,522	6,123,852
Principal and interest from property dispositions	727,381	876,698
Processing	344,228	402,282
Other	15,759	110,314
	7,651,890	7,513,146
Expenses		
Production	2,392,162	2,004,787
General and administrative	1,002,933	830,350
Interest on long-term debt	108,710	198,664
Depletion and depreciation	1,957,870	1,745,978
	5,461,675	4,779,779
Earnings before preferred share dividends and extraordinary item	2,190,215	2,733,367
Dividends on preferred shares of a subsidiary company	1,259,398	1,396,932
Earnings before extraordinary item	930,817	1,336,435
Gain on sale of subsidiary	282,455	9,599
Net earnings	$ 1,213,272	$ 1,346,034
Per Common Share		
Net earnings — Basic	$ 0.04	$ 0.05
— Fully diluted	$ 0.04	$ 0.05
Cash flow — Basic	$ 0.11	$ 0.12
— Fully diluted	$ 0.10	$ 0.12

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF DEFICIT
SIX MONTHS ENDED JUNE 30, 1988
(unaudited)

	1988	1987 (restated)
Deficit at beginning of period		
As previously reported	$ —	$(55,937,150)
Adjusted for settlement of liability		(1,432,900)
As restated	(55,568,401)	(57,370,050)
Net earnings	1,213,272	1,346,034
Deficit at end of period	$(54,355,129)	$(56,024,016)

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF SOURCE AND USE OF CASH
SIX MONTHS ENDED JUNE 30, 1988
(unaudited)

	1988	1987 (restated)
Operating Activities		
Earnings before extraordinary item	$ 930,817	$ 1,336,435
Depletion and depreciation	1,957,870	1,745,978
Working capital provided by operations	2,888,687	3,082,413
Net change in non-cash working capital items	554,845	(2,174,945)
	3,443,532	907,468
Investing Activities		
Additions to fixed assets		
Current operations	(3,162,753)	(1,034,567)
Flow-through share arrangement	(726,027)	(576,985)
Collection of notes receivable	282,455	9,599
Financing Activities		
Decrease in bank loan	(2,970,000)	(390,000)
Decrease in liability to limited partnership	(479,498)	—
Sale of 8.75% convertible debentures net of financing costs	9,250,000	—
Common shares issued and to be issued		
Pursuant to flow-through share arrangement	726,027	576,985
For cash	750	7,500
On liability settlement	200,000	—
Pursuant to employee savings plan	50,441	—
Increase (decrease) in cash	6,614,927	(500,000)
Cash at beginning of period	—	2,594,662
Cash at end of period	$ 6,614,927	$ 2,094,662